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OO RUEHAG RUEHDF RUEHIK RUEHLZ RUEHROV
DE RUEHFT #0568/01 0581004
ZNR UUUUU ZZH
O 271004Z FEB 08
FM AMCONSUL FRANKFURT
TO RUEHC/SECSTATE WASHDC IMMEDIATE 4831
INFO RUEATRS/DEPT OF TREASURY WASHDC IMMEDIATE
RUCNMEM/EU MEMBER STATES IMMEDIATE
RUCNFRG/FRG COLLECTIVE IMMEDIATE

UNCLAS SECTION 01 OF 02 FRANKFURT 000568

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E.O. 12958: N/A
TAGS: [EFIN](#) [ECON](#) [GM](#)
SUBJECT: German Private Bank Successes Highlight State Bank
Failures: The Outlook from Frankfurt

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REF: 08 Leipzig 0002

11. Summary. With 2007 annual reports coming in from the German banking sector, Germany's two largest private banks registered record earnings despite losses in the second half of the year from subprime-related investments. The success of the large private banks stands in contrast to several smaller state-owned banks that have experienced significant losses and, in some cases, been forced to rely on government intervention. While the recent shake-ups have altered the German banking landscape, Frankfurt-based executives and officials foresee no drastic changes in Germany's three-pillar banking system and little cause for panic within the sector. End Summary.

Private Bank Reports in, Results Good despite Turbulence

12. In early February, both Deutsche Bank and Commerzbank, Germany's two largest private banks, reported record earnings for 2007 despite write-offs in the second half of the year due to subprime-related investments. Deutsche Bank reported 6.5 billion euros (\$9.55 billion) in profits and 2.3 billion euros (\$3.38 billion) in write-offs, while Commerzbank announced a net profit of 1.92 billion euros (\$2.82 billion) and 248 million euros (\$367 million) in write-offs. On a less rosy note, Germany's third largest private bank, the Allianz subsidiary Dresdner Bank, posted a meager profit of only 450 million euros (\$661.5 million), mainly due to subprime losses, and announced that its K2 special investment vehicle would require a rescue facility.

13. In a conversation with Pol Off, a senior Frankfurt-based Commerzbank executive said the performance of Germany's private banks was strong in this turbulent period because they were solely responsible for the risks they accrued. He pointed out that troubled state banks (Landesbanken) such as WestLB and SachsenLB and the small private bank IKB had pursued "reckless" investment strategies that led to ruin because these banks always had the assurance of state intervention in case of serious trouble.

14. A Deutsche Bank executive noted that Germany's private banks had to report on a quarterly basis, as opposed to annually in the case of the state banks, and therefore had done better at disclosing exposure in a timely fashion. According to the executive, Deutsche Bank was, overall, not strongly affected by the turmoil because of its diversified investment portfolio, including strong returns in emerging markets. The Commerzbank executive highlighted his bank's strong returns on investments in Eastern Europe and in Germany's small and medium-sized businesses, which more than offset losses from subprime vehicles.

15. Several sources confirmed rumors that Deutsche Bank and Commerzbank would be interested in buying the government-owned Postbank. Postbank has around 14.5 million private account holders, a business sector attractive to the private banks, while Postbank needs the access to other markets that the private banks provide. Such an acquisition would shake up the banking sector in Germany by creating what would be Germany's preeminent bank.

State Bank System Battered but Holds Up

16. Losses by smaller banks have fueled speculation that the financial turmoil will shake up the three pillar German banking system which separates private banks, savings and state banks (Sparkassen and Landesbanken), and cooperative banks. Experts in Frankfurt, however, saw little prospect for such a serious challenge to the state bank system, where WestLB is in trouble, SachsenLB has become insolvent and other banks have suffered heavy losses. An official at the Bundesbank told Pol Spec that the three pillar system could only be broken up by political forces, not economic ones. The state banks enjoyed official government backing until 2005 and since that time still maintain close relations with the state governments which often see the banks as a vital economic and political asset. Landesbank Baden-Wuerttemberg's pending takeover of SachsenLB (which is accompanied by a guarantee from the state of Saxony) and the state bailout of WestLB again seemed to show that consolidation was likely to occur only within, not between, each of the three banking pillars and private banks would not have the opportunity to acquire these entities.

17. A senior executive at Helaba, the state bank of Hesse and Thuringia, pointed out that the financial turmoil had only affected four of the six state banks and that his bank and NordLB remained unaffected because they pursued a more conservative, but ultimately

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more successful business model. He dismissed rumors of more mergers among the state banks or a possible pooling of losing assets, saying that the healthy state banks would not have much interest in partnering with the troubled ones. His outlook was confirmed on February 21, when Hesse Economics Minister Alois Rheil said the board of Helaba had cooled to the idea of taking over WestLB, presumably in light of new evidence of the latter bank's poor financial position.

18. The Commerzbank executive called troubled WestLB "the biggest casino in Germany in the last fifteen years," and highlighted the fact that Finance Minister Peer Steinbrueck was once Minister President of North-Rhine Westphalia and therefore must have known about the bank's risky investment strategy. The executive questioned Steinbrueck's credibility in his recent calls for more transparency in the banking sector in light of his former role. The recent bailout of WestLB and the state-guarantee in the acquisition of SachsenLB show that state governments still play an active role in managing the state banks. The executive criticized the relationships between the banks and the public officials, who often sit on their boards, commenting that board memberships were treated as perks and the members provided little real oversight of the banks' activities. He predicted that the number of state banks would decline, but that there would be no real changes to this uniquely German system.

18. Comment: From the viewpoint of the Frankfurt business community, the recent spate of annual reports points to basic stability in the private banking sector and provides grounds for optimism that the worst of the subprime turmoil is already behind us. At the same time, the success of the private banks in a sink-or-swim environment only highlights the lack of accountability among some state banks. While outsiders have criticized the state banking system for enabling banks to pursue risky strategies, it will most likely endure unless there is a political change of heart. End Comment.

19. This cable has been coordinated with Embassy Berlin, which will be providing a broader analysis of the current state of banking in Germany in line with its ongoing reporting on the impact of the

subprime financial crisis, and also with Consulate General
Duesseldorf and Consulate General Leipzig.

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